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# Fiscal stabilization in the euro area: the role of national fiscal policy

Cinzia Alcidi – CEPS –

Intereconomics Conference – A stabilization function for the euro area

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# Outline:

- Motivation
- Stabilization through fiscal policy in euro area MS
  - Discretionary fiscal policy over the cycle
  - Shock absorption capacity of government's budget
- Conclusions

# Motivation

- Debate about the need for a stabilization function for the euro area requires understanding of the role of fiscal policy at national level
- Link with the fiscal governance and fiscal rules in particular
- Question: is domestic fiscal policy an effective tool for stabilization in the euro area?

# How to deal with shocks in a MU?



- Theory identifies different mechanisms:
  - Price and wage adjustments – not exchange rate
  - Mobility of factors of production: labour and capital
    - Rather limited in the EA
  - Fiscal risk-sharing mechanisms through federal budget
    - Not existing in the EA – is it necessary?
  - National fiscal policy in MS: discretionary fiscal policy + automatic stabilizers
    - Main tool in the EA

# The current system of fiscal governance and fiscal policy

- EU budget, unlike in federations, has no (formal) stabilization purpose
- Complex system of rules
  - Rules deemed necessary because of single monetary policy
  - Problem of low enforcement – national fiscal sovereignty & MS vs. EA perspective
- One key function of fiscal policy: dealing with (negative) shocks
  - From a country perspective: emphasis on recessions
    - Do fiscal rules induce counter-cyclicalities? (usually relative to the potential output)
  - From a EA-wide perspective: emphasis on asymmetric shocks
    - Fiscal rules are not really the key issue

# Cyclicalities of fiscal policy in the EMU?(I)



- Against expectations (before EMU)
  - asymmetric shocks not rarer (e.g. endogenous OCA theory)
  - No fiscal buffers have been built in most countries
- Everyone seems to agree that fiscal policy should be countercyclical. But in reality is not, almost never
- Often rules are meant to push government to pursue countercyclical policies
- What about EU rules?
  - EU rules were not designed to be countercyclical but to promote discipline, which is not necessarily the same
  - The asymmetry of the 3% deficit: weak constraint in upturns
    - Rules have been adjusted over time to be 'smarter'

# Cyclical policy in the EMU? (II)



- Large literature on fiscal policy over the cycle but findings are not very robust
- Few key findings:
  - Fiscal policy tends to be pro-cyclical in good times (e.g. Turrini, 2008)
  - Often deficit bias: governments tend to spend both in good and in bad times
- Explanations for lack of robustness:
  - Information availability – real time data issue
  - Measurement of discretionary fiscal policy (levels, changes, lags, contemporaneous..)
- Focus is on discretionary component of the government budget
- During the EA crisis many argued that austerity amplified the recession rather than smoothing its effect
  - Was it induced by the existing fiscal rules?

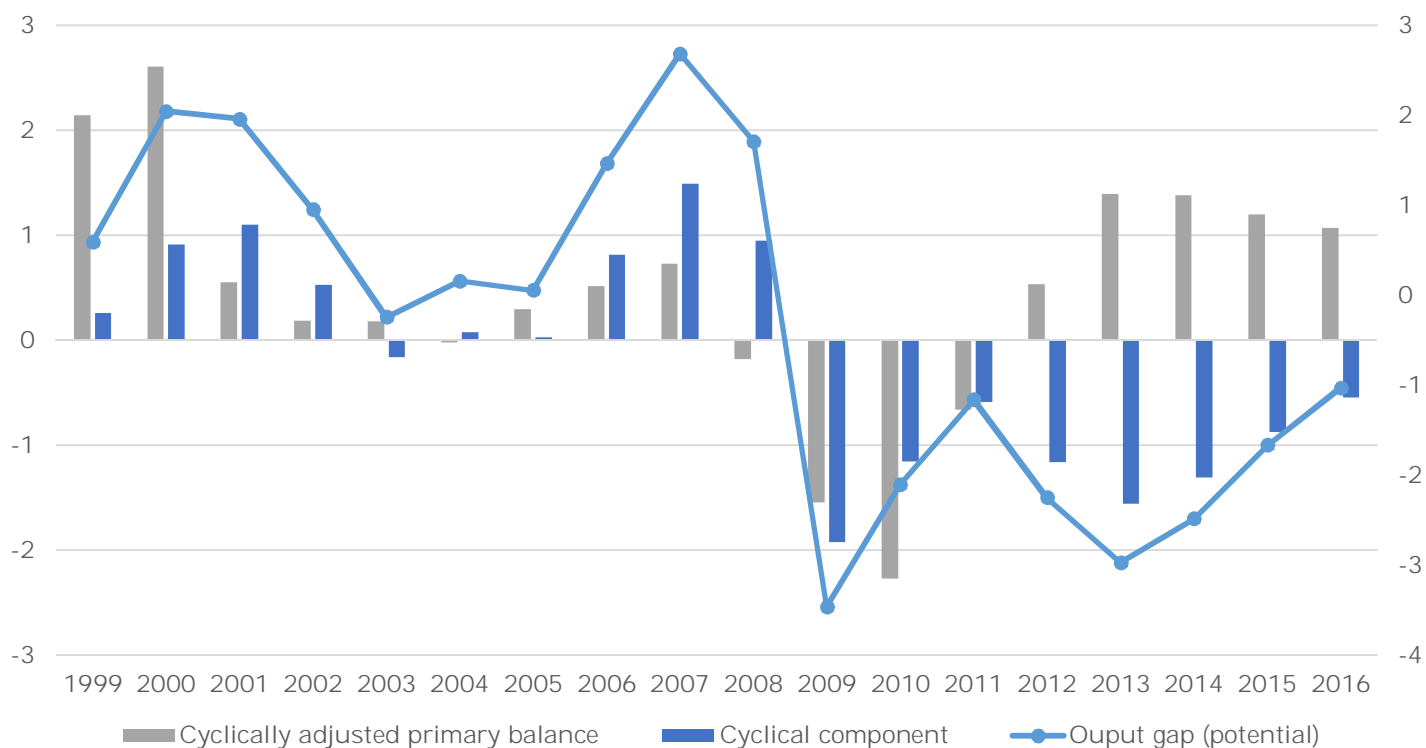
# Cyclical policy in the EMU? (III)

- We also produced new empirical analysis:
  - No evidence of pro-cyclicality in the euro area, ex-post and real time data
  - Discretionary measures seem to be independent of the cycle
    - In line with Carnot and Castro (2016)
  - We try to disentangle the role of fiscal rules and of market pressure
    - Market pressure (high spreads) and rules induce “prudent” fiscal stance but do not systematically affect cyclical policy
    - Market pressure, rather than rules, induce pro-cyclicality in bad time



# Discretionary fiscal policy vs. automatic stabilizers

Euro Area (15): Primary balance decomposition, % of GDP



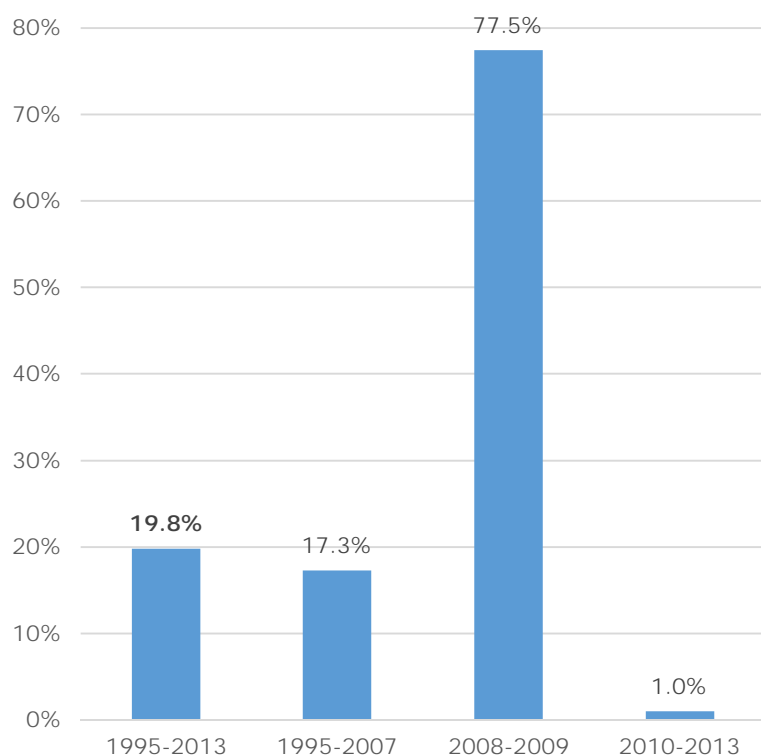
Source: Ameco

# Fiscal policy, the cycle and the shocks

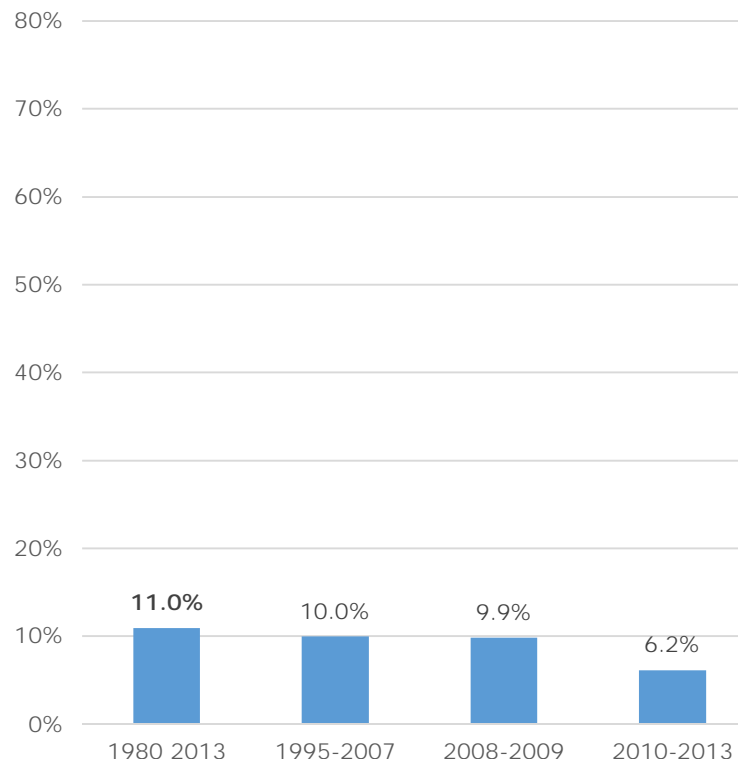
- In the EA stabilizers should be the most important tools to respond to shocks
  - Empirical analysis on the cyclicity of automatic stabilizers provide little insight
- We choose a different framework to look at stabilization capacity of fiscal policy
  - Asdrubali et al. (1996): framework which is usually used to measure inter-state risk-sharing
  - In the vein of Arreaza et al. (1998) we estimated the share of a variance shock to the GDP absorbed by government's budget and its components
  - Focus on the EA as whole
  - Moving from output gap (country perspective) to asymmetric shocks (EA-wide perspective)

# The role of fiscal policy as shock absorber in the EA (US as benchmark)

EA: Smoothing through national fiscal policy (1995-2013)



US: Smoothing through Federal budget (1980-2013)



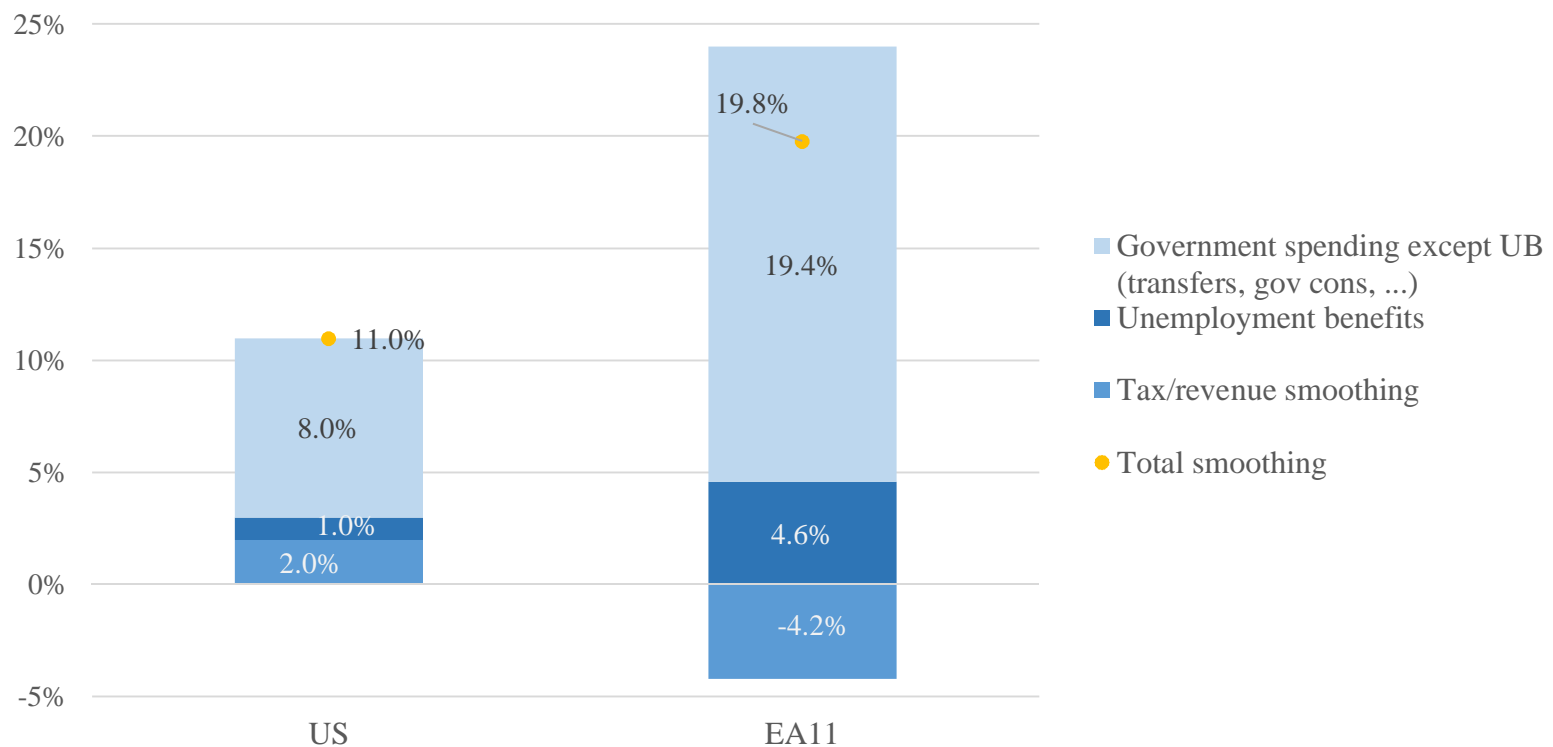
Note: The bars represent the percentages of states' output shocks absorbed through the government budget; federal in the US and domestic in the EA.

Equations are estimated using OLS with time fixed effects, correcting for AR(1) process in the error term. Standard errors are corrected for panel heteroscedasticity.

Source: Alcidi and Thirion, 2017 - Authors' calculation based on data from Ameco and BEA

# Shock absorption capacity by budget items: EA (US as benchmark)

Shock absorption capacity of selected budget items: EA (US as benchmark) 1995-2013



*Note:* The bars represent the percentages of states' output shocks absorbed through the different government budget items. Equations are estimated using OLS with time fixed effects, correcting for AR(1) process in the error term.

*Source:* Alcidi and Thirion, 2017 - Authors' own calculations based on data from AMECO, SOCEXP (OECD) and BEA.

# Concluding remarks

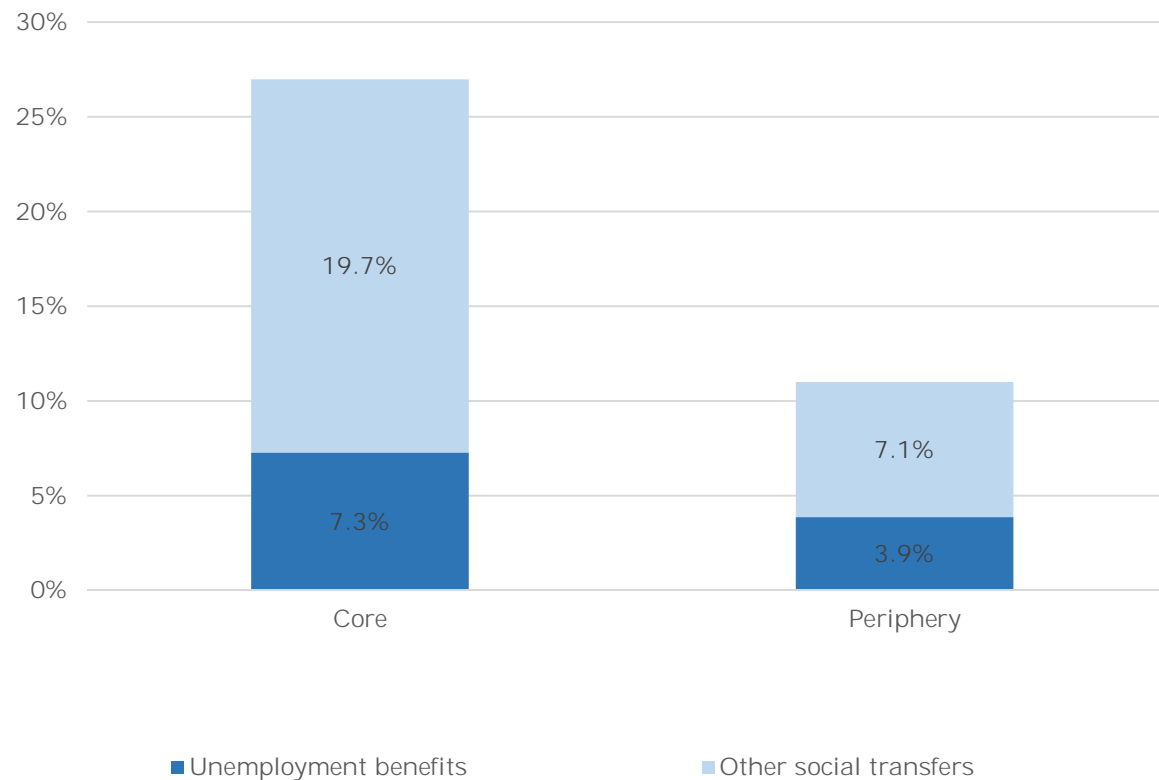
- Is domestic fiscal policy an “effective” stabilization tool in the EA ?
- Discretionary fiscal policy more neutral than stabilizing – in terms of cyclicity – and rules do not seem to be relevant
- When looking at the absorption of asymmetric shocks the picture of fiscal policy is less bad than usually assumed
- UI seems to perform better than in the EA than in the US
  - Discretionary fiscal policy much more important in the US
  - We do not consider symmetric shocks
- It remains the issues of symmetric shocks and large shocks against which domestic automatic stabilizers tend to loose effectiveness

**THANK YOU  
FOR YOUR  
ATTENTION**

# Fiscal policy as shock absorber: core vs. periphery

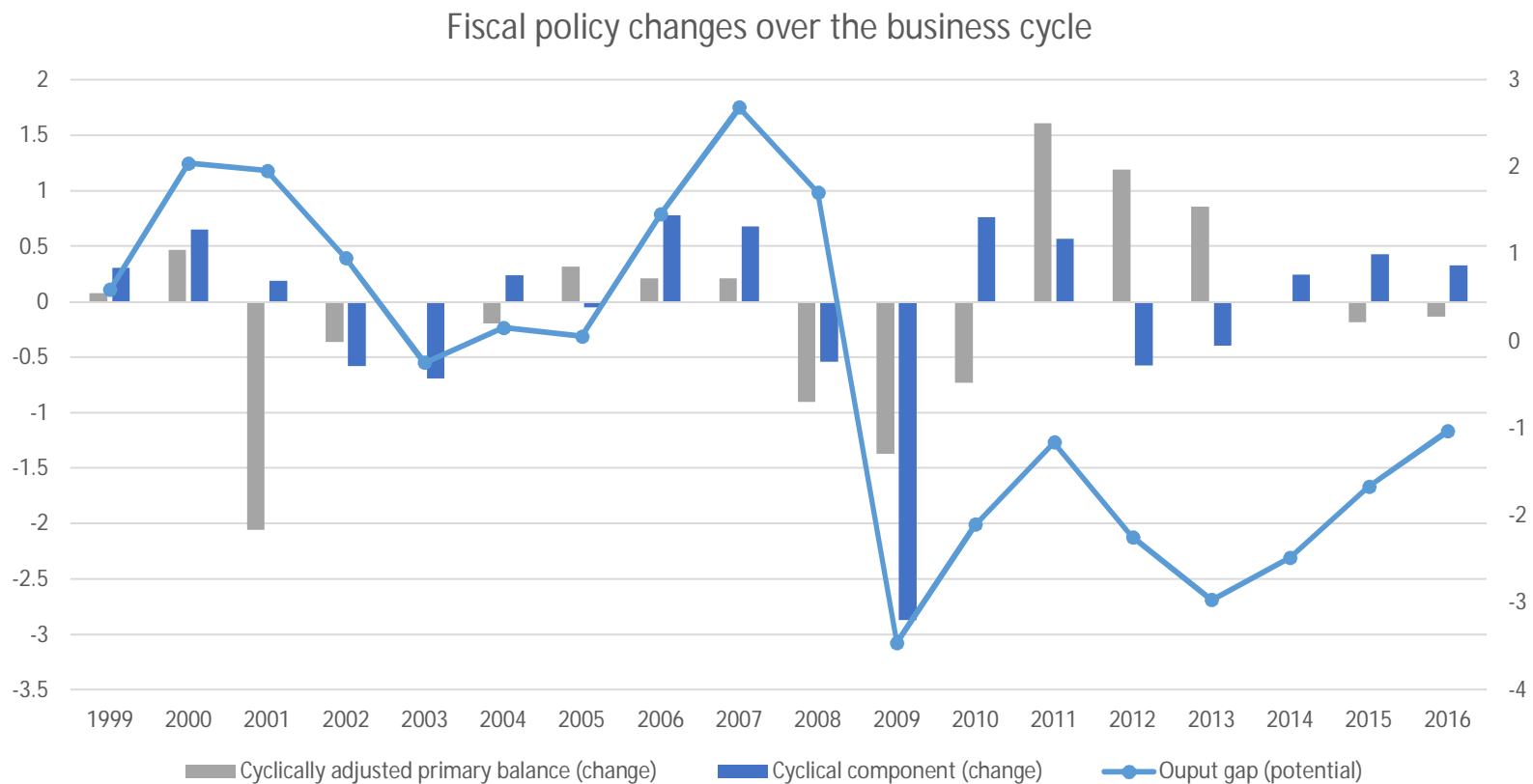
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Shock absorption capacity of selected budget items: Core vs. Periphery



# Discretionary fiscal policy vs. automatic stabilizers (bis)

Euro Area (15): Primary balance decomposition, change from previous period, % of GDP







[www.ceps.eu](http://www.ceps.eu)



[Cinzia.alcidi@ceps.eu](mailto:Cinzia.alcidi@ceps.eu)



[@CEPS\\_thinktank](https://twitter.com/CEPS_thinktank)



1) **Government budget:**  $\Delta \log DNI_{i,t} - \Delta \log(DNI - Gov Saving)_{i,t} = a_t^{pub\ s} + \beta^{pub\ s} \Delta \log GDP_{i,t} + \varepsilon_{i,t}$

2) **State fiscal policy item (x):**  $\Delta \log DNI_{i,t} - \Delta \log(DNI \pm x)_{i,t} = a_t^{if} + \beta^{if} \Delta \log GDP_{i,t} + \varepsilon_{i,t}$

**Net federal transfers to states**

3) **Federal tax and transfers:**  $\Delta \log SI_{i,t} - \Delta \log DSI_{i,t} = a_t^t + \beta^t \Delta \log GSP_{i,t} + \varepsilon_{i,t}$

**Federal budget item (x):**  $\Delta \log SI_{i,t} - \Delta \log (SI \pm x) = a_t^t + \beta^t \Delta \log GSP_{i,t} + \varepsilon_{i,t}$

Fiscal policy element (x):  $\Delta \log DNI_{i,t} - \Delta \log(DNI \pm x)_{i,t} = a_t^{if} + \beta^{if} \Delta \log GDP_{i,t} + \varepsilon_{i,t}$